



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	03/29/05	Bill No:	SB 564
Tax:	Cigarette and Tobacco Products	Author:	Torlakson
Related Bills:			

BILL SUMMARY

This bill would:

- Impose an additional excise tax on cigarettes of five cents (\$0.05) per cigarette, or \$1.00 per package of 20, and impose an equivalent compensating floor stock tax. The revenue from the tax increase would be deposited into the California Healthy Children Trust Fund, which this bill would create, and
- Exclude from the 0.85 percent cigarette distributor discount the additional excise tax on cigarettes proposed by this measure.

Summary of Amendments

The amendments to this bill since the previous analysis 1) increase the additional cigarette tax from \$0.50 to \$1.00 per package of 20 cigarettes, 2) revise the programs the additional cigarette tax revenues fund, 3) allow for backfill from the newly created California Healthy Children Trust Fund to the California Children and Families Trust Fund (Proposition 10), and 4) make other clarifying changes.

ANALYSIS

Cigarette Tax Increase

Current Law

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2004-05 is 46.76 percent.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children

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and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

Proposed Law

Among other things, this bill would add Article 4 (commencing with Section 30133) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$1.00 per package of 20 cigarettes. The tax would be imposed beginning January 1, 2006. The bill would also impose a compensating floor stock tax on the January 1, 2006 cigarette inventory of a dealer and wholesaler, and a cigarette indicia adjustment tax on the January 1, 2006 affixed and unaffixed cigarette tax stamp inventory of a licensed distributor.

The Board would deposit the proceeds from the tax increase into the California Healthy Children Trust Fund, which this bill would create in the State Treasury. For the 2005-06 fiscal year and each fiscal year thereafter, the moneys deposited in the California Healthy Children Trust Fund would be continuously appropriated to the Department of Health Services (DHS) for expenditure to fund specified programs. These programs would be funded according to unspecified allocation formula to the following:

- Training, education, nutrition, and physical activity.
- Preventative health programs designed for children one through five years of age.
- Preventative health programs designed for children six through seven years of age.
- Preventative health programs designed for children eight through 10 years of age.
- California Tobacco Control Program for the implementation of a state-of-the-art tobacco control program.
- Programming in after-school programs targeted towards the prevention of childhood obesity and diabetes, including, but not limited to, physical activity and nutrition.
- Community-based programs to match funds raised locally for the research, prevention, and treatment of pediatric AIDS, obesity, diabetes, and childhood cancers.
- Research and the prevention of other cancers, including, but not limited to, lung cancer.

This bill would also require the Board to determine, within one year of enactment, the additional taxes imposed on cigarettes has had on the consumption of cigarettes in this state. To the extent that a decrease in consumption is determined by the Board to be the direct result of the additional taxes, the Board would be required to determine the fiscal effect the decrease in consumption has on programs funded pursuant to the Cigarette and Tobacco Products Surtax Fund (Proposition 99), the Breast Cancer Fund and the California Children and Families Trust Fund (Proposition 10). For the 2006-07 fiscal year and each fiscal year thereafter, the Board would determine the amount of the decrease in revenue available to the funds and program affected by the additional tax.

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That amount would be transferred from the California Healthy Children Trust Fund and deposited in the Cigarette and Tobacco Products Surtax Fund, the Breast Cancer Fund, and the California Children and Families Trust Fund to reimburse revenue losses that are a consequence of this bill.

As a tax levy, the bill would become effective immediately upon enactment.

Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to provide committed funding, in part, for preventative health programs for children, and tobacco control and cessation programs.
2. **Summary of amendments.** The March 29, 2005, amendments increase the additional cigarette tax from \$0.50 to \$1.00 per package of 20 cigarettes and revise the programs the additional cigarette tax revenues fund. The amendments also allow for backfill from the newly created California Healthy Children Trust Fund to the California Children and Families Trust Fund (Proposition 10) to reimburse any losses that occur as a result of the additional cigarette tax, and make other clarifying changes.
3. **This measure does not contain a corresponding tax increase on tobacco products.** However, the \$0.50 cigarette tax increase would increase the tobacco products tax rate July 1, 2006 as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of tax imposed on cigarettes. As such, a tax increase on tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

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It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the California Healthy Children Trust Fund. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

3. **This measure would increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes is not specifically exempted or excluded, it is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed. The impact on state and local sales and use tax revenues is shown in the Revenue Estimate.

4. **This bill contains floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on a dealer's and wholesaler's cigarette inventory and an adjustment tax on a distributor's inventory of affixed and unaffixed cigarette indicia. These provisions are important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by \$34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35-cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37-cent stamps which were sold beginning January 1, 1994. This huge inventory stockpiling translated into \$2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

While there are additional costs associated with administering the floor stock tax and the cigarette indicia adjustment tax, the revenue substantially compensates for that cost.

5. **Would an increase in the cigarette tax increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. Board staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$292 million annually. That estimate was only for

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evasion of cigarette taxes, and did not include associated evasion of other taxes, such as sales and use, tobacco products or income taxes.

A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates. For example, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices excluding taxes: Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an additional excise tax on cigarettes of \$0.50 per package of 20, and impose an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. It is assumed that this increase would cause a correlated increase in tax evasion based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement.

6. **Suggested technical amendments.** This measure would impose an additional excise tax upon every distributor of cigarettes at the rate of five cents (\$0.05) for each cigarette that is distributed. For purposes of consistency with existing law, the amount of the proposed additional tax should be referred to in "mills" rather than "cents." For example, five cents is fifty mills.
7. **This bill should contain a specific appropriation to the Board.** This bill would impose an additional excise tax on cigarettes, beginning January 1, 2006, which is in the middle of the state's fiscal year. In order to properly notify cigarette distributors, wholesalers and retailers of the additional tax, develop computer programs, reporting forms, and hire appropriate staff, an adequate appropriation would be required to cover the Board's administrative start-up costs that would not already be identified in the Board's 2005-06 budget.
8. **Backfill of existing cigarette tax funds.** This bill would require the Board to determine the effect that the additional cigarette taxes has had on the consumption of cigarettes in this state. To the extent that a decrease in consumption is to be a direct result of the additional tax, the Board would be required to determine the fiscal effect on programs funded pursuant to the Cigarette and Tobacco Products Surtax Fund (Proposition 99), the Breast Cancer Fund, and the California Children and Families Trust Fund. The amount of the decrease in revenue available to the funds and programs would be transferred from the California Healthy Children Trust Fund and deposited in the Cigarette and Tobacco Products Surtax Fund (Proposition 99), the Breast Cancer Fund and the California Children and Families Trust Fund.

Proposition 10's backfill (Health and Safety Code §130105) requires the Board to determine the fiscal effect on the funding of any Proposition 99 (the Tobacco Tax and Health Protection Act of 1988) state health-related education or research programs in effect as of November 1, 1998. As such, *it limits the backfill to only two*

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of the six accounts within the Cigarette and Tobacco Products Surtax Fund – the Health Education Account and the Research Account. However, this measure would allow for backfill to all six accounts.

Furthermore, it should be noted that this measure would not backfill the General Fund.

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ANALYSIS**Distributor Discount****Current Law**

Section 30161 of the Cigarette and Tobacco Products Law generally provides that the cigarette tax imposed with respect to the distribution of cigarettes shall be paid by distributors through the use of stamps or meter impressions. Section 30163 requires that an appropriate stamp or meter impression be affixed to, or made on, each package of cigarettes prior to distribution of the cigarettes, except as otherwise provided.

Currently, Section 30166 of the Cigarette and Tobacco Products Tax Law provides that stamps and meter register settings be sold to licensed distributors at their denominated values less 0.85 percent. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps.

Proposed Law

This provision would amend Section 30166 of the Cigarette and Tobacco Products Tax Law to exclude the additional tax on cigarettes proposed by this measure from the 0.85 percent distributor's discount.

In General

The distributor discount per roll of stamps (30,000 stamps) since August 1, 1967 is as follows:

Period	Tax Increase Pursuant To:	Stamp Value¹	Roll Value²	Licensed Distributors Discount	Discount Amount Per Roll
08/01/67-09/30/67	SB 556 (Ch. 963, Stats. 1967)	\$0.07	\$2,100	0.85 percent	\$17.85
10/01/67-12/31/88	SB 556 (Ch. 963, Stats. 1967)	\$0.10	\$3,000	0.85 percent	\$25.50
01/01/89-12/31/93	Proposition 99	\$0.35	\$10,500	0.85 percent	\$89.25
01/01/94-12/31/98	AB 478 (Ch. 660, Stats. 1993)	\$0.37	\$11,100	0.85 percent	\$94.35
1/1/99-Current	Proposition 10	\$0.87	\$26,100	0.85 percent	\$221.85

¹ Per package of 20 cigarettes

² One roll is equivalent to 30,000 stamps

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Background

In 1960, Assembly Bill 11 (Ch. 12) added Section 30194 to the Revenue and Taxation Code to provide, in part, a 2 percent discount on purchases of tax indicia. In 1961, Assembly Bill 714 (Chapter 884, Stats. 1961) repealed Section 30194 and added Section 30166, which provided that stamps and meter register setting shall be sold at their denominated values less 2 percent to licensed distributors.

Senate Bill 556 (Ch. 963, Stats. 1967) amended Section 30166 to lower the discount provided to licensed distributors from 2 percent to 0.85 percent.

During the 1984 Legislative Sessions, Senate Bill 1108, which provided for an annual adjustment in the percentage discount based on an inflation adjustment factor, was passed by the Legislature, but vetoed by the Governor. Governor Deukmejian's veto message states, in part, the following:

"While I recognize that discount rates connected with affixing stamps and meter register settings have remained unchanged for many years despite inflation, I believe the adjustments proposed by this bill would sustain a practice which may no longer be needed. Further, adjusting the discount rates would result in a substantial benefit to cigarette distributors at the direct expense of local governments and California taxpayers."

In 1985, Senate Bill 1640, a bill substantially similar to SB 1108, was introduced. However, that bill failed to pass from its house of origin by the deadline.

Assembly Bill 1768 (2002) would have provided that the 0.85 percent cigarette distributor discount only applies to the first \$0.10 of the value of the stamp or meter impression. However, that provision was amended out of the bill.

COMMENT

The Board staff does not foresee any administrative problems with this provision. This provision would simply limit the discount provided to licensed distributors for purchases of stamps and meter register settings. Accordingly, enactment of this measure would not affect the Board's administration of the Cigarette and Tobacco Products Tax Law.

COST ESTIMATE

A detailed cost estimate is pending. However, the Board would incur costs to notify taxpayers, develop returns, program computers, develop and enforce compliance and audit efforts to ensure proper reporting, and administer a floor stock tax.

A tax increase as large as the one proposed by this bill would require enhanced enforcement efforts to ensure compliance. Costs would be incurred for greater audit efforts to ensure that the floor stock tax is properly reported and collected, greater compliance efforts for additional billings and delinquencies, and an increased investigative staff presence due to increased tax evasion.

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REVENUE ESTIMATE**Background, Methodology, and Assumptions**Fiscal Year 2005-06

Cigarette Tax. Tax-paid cigarette distributions were about 1,200 million packs in calendar year 2004. Because of stronger enforcement provisions enacted in recent years, we expect tax paid distributions to stay at approximately this level in 2005 under current law.

Based on previous tax increases, we believe an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause an additional decrease of 12.7 percent in tax paid distributions. (This estimate assumes a price elasticity of demand of -0.50, applied to estimated average 2004 prices of approximately \$4.00 per pack.)

A corresponding floor stock tax, assuming a three weeks supply of cigarettes, [approximately 69.2 million packs $((1,200 / 52) \times 3 = 69.2)$], would produce \$69.2 million in additional revenue (69.2 million packs \times \$1.00 = \$69.2 million).

Since the new rate takes effect January 1, 2006 and the proposal has a floor stock tax, the impacts for fiscal year 2005-06 are about half of the full year impacts for cigarettes.

Tobacco Products Tax. The Board is expected to set the tobacco products tax rate for fiscal year 2005-06 before the fiscal year begins.³ The proposed \$1.00 per pack increase in the cigarette excise tax rate will not affect the tobacco products tax rate until fiscal year 2006-07.

Fiscal Year 2006-07

Tobacco Products Tax. Pursuant to Proposition 99, this measure would result in an additional tax on tobacco products at a rate equivalent to the new \$1.00 per pack rate this measure would impose on cigarettes. This tax increase would be effective on July 1, 2006.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2004-05 fiscal year is \$0.1465. The current tax rate on cigarettes is \$0.0685 per cigarette. The tobacco tax rate for 2004-05 is 46.76 percent ($\$0.0685 / \$0.1465 = 0.4676$). Under this bill, the tobacco products tax rate would rise from 47.76 percent to 80.89 percent in fiscal year 2006-07.

³ As used here, the term "tobacco products" refers to all tobacco products except for cigarettes. Examples of such products include chewing tobacco, snuff, pipe tobacco, and roll-your-own cigarette tobacco.

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The wholesale cost (or wholesale sales) of tobacco products was about \$109 million in calendar year 2004. Because of stronger enforcement provisions enacted in recent years, we expect wholesale costs to stay at approximately this level in 2005 under current law.

Based on previous tax increases, an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. We estimate the sales of tobacco products would decline by 11.6 percent, similar to the percentage decline in cigarette sales.⁴

Because of the resulting tax increase for Proposition 99 resulting from this bill, tobacco products revenues for Proposition 99 funds increase by \$29.1 million in fiscal year 2006-07. However, because of the expected 11.6 percent decline in consumption, Proposition 10 tobacco products revenues decline by \$2.2 million. The net increase in tobacco products revenues is \$26.9 million.

Backfill Revenues. This bill provides “backfills” to the Cigarette and Tobacco Products Surtax Fund (Proposition 99), the Breast Cancer Fund, and the California Children and Families Trust Fund (Proposition 10) that are conceptually similar to the Proposition 10 backfills. That is, these funds are compensated for revenue losses caused “as a direct result of the imposition of the [SB 564] tax.” As mentioned earlier, we estimate that the proposed tax increase leads to a 12.7 percent decline in tax-paid cigarette distributions, which proportionately reduces revenues of all funds that receive cigarette excise tax revenues. The General Fund does not receive a backfill under this bill.

One difference from the Proposition 10 and this bill's backfills is that this bill provides backfills for all six Proposition 99 accounts, while the Proposition 10 backfills only cover 25 percent of the revenues in the Proposition 99 accounts.

We estimate backfills of \$3.0 million for the Breast Cancer Fund, \$38.0 million for the Proposition 99 Fund, and \$76.0 million for the Proposition 10 Fund. The total backfill amount for all three funds is estimated to be \$117.0 million. These figures are the results of a 12.7 percent decline in tax-paid distributions multiplied by their respective tax rates.

Sales and Use Tax Impacts

We assume that all of the cigarette and tobacco products tax increases are passed on to consumers.

⁴ The current tobacco products tax rate is the equivalent of \$1.37 per pack, \$0.87 per pack for Proposition 99 funds and \$0.50 per pack for Proposition 10 funds. Since the \$1.37 per pack tax rate for tobacco products is higher than that of cigarettes (\$0.87 per pack), a \$1.00 per pack tax increase implies a slightly smaller price increase for tobacco products than it does for cigarettes. Consequently, the decline in tobacco products sales (11.6 percent) is slightly less than it is for cigarette sales (12.7 percent).

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Revenue Summary

The revenue impacts of this bill are shown in the table below. The first complete year that all the provisions of the proposal are in effect will be fiscal year 2006-07. For fiscal year 2006-07 the California Healthy Children Trust Fund (created by SB 564) will receive \$1,048.0 million. The existing cigarette excise funds will lose a total of \$132.3 million, resulting in a net gain of \$915.7 million in all cigarette excise taxes. The impacts on tobacco products tax revenues and sales tax revenues are also shown in the table. Tobacco products revenues increase by \$26.9 million, and total state and local sales tax revenues increase by \$74.7 million in FY 2006-07.

Revenue Impacts Summary - SB 564	Fiscal Year	
	2005-06	2006-07
Cigarette Excise Tax Revenues by Fund		
General Fund	-\$6.7	-\$15.2
Breast Cancer Fund	-\$1.3	-\$3.0
Proposition 99 Fund	-\$16.9	-\$38.0
Proposition 10 Fund	-\$33.7	-\$76.0
California Healthy Children Trust Fund	\$465.1	\$1,048.0
Total Cigarette Excise Tax Revenues	\$406.4	\$915.7
Floor Stocks Tax	\$69.2	\$0.0
Tobacco Products Tax Revenue Increase (Proposition 99)	\$0.0	\$26.9
Total Excise Tax Increase (Cigarettes and Tobacco Products)	\$475.7	\$942.6
State Sales & Use Tax (5.25%)	\$25.0	\$49.5
Total State	\$500.6	\$992.1
Local Sales & Use Tax (at 2.0%)	\$9.5	\$18.9
Transit Tax (at 0.67%)	\$3.2	\$6.3
TOTAL	\$513.3	\$1,017.3

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